On Economic Growth, Inflation and Measures Taken by the Government

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In the past two decades, Vietnam gained encouraging achievements after its economic reform was launched in 1986: high growth rate, low inflation rate and good results of the poverty alleviation program. Its policy on international integration seems successful. One year after it got accession to the WTO, its foreign trade enjoyed a boom (export rose by 20.5% and import 25.6%), the FDI increased strongly (US$20 billion registered and 20% of it has been disbursed), local trade developed well with development of supermarkets with diverse goods in large quantities. These factors helped promote the growth rate (8.5%).

Besides the achievements, however, the economy shows negative signs: a high inflation rate (12.6% - much higher than the growth rate of 8.5%); increased prices in the realty market; and wage earners' inability to buy houses. In addition, traffic congestion in Hà Nội and HCMC becomes more serious, the living conditions go from bad to worse because of severe pollution. According to estimates by international organizations, high increases in the inflation rate and its bad effects have ruined the economic growth and widened the gap between the rich and the poor. The living standards of wage- earners and peasants fell drastically because their real income contracted.

What are causes of the inflation? What are effects of quality of economic growth and performance of investment on the inflation? What solutions introduced by the Government can ensure a growth rate of 8% or 9% for 2008 and keep the inflation rate below it? Answering these questions is no easy task. In this article, we want to employ some models relating to economic growth and inflation to explain the sequence of events, discuss solutions from the Government and give our commentaries and suggestions about economic policies under current conditions.

1. Reviewing the inflation in Vietnam

For the first time, the press in Vietnam starts to discuss unsolvable problems relating to the policy-making process in a voluntaristic manner with preset targets instead of relying on a scientific thinking. When the Ministry of Finance accelerates the disbursement in order to maintain a high growth rate, the SBV meets with difficulties in limiting the money supply with a view to curbing the inflation. In its turn, the Ministry of Trade and Industry wants to depreciate the VND to promote export and make up for losses caused by the inflation. But billions of dollar from abroad and sales of crude oil are flooding the market, making the VND go high against the dollar. And what is the right and realistic policy? We'd better start with some analyses of the financial- monetary system.

According to Professor R.I. McKinnon from the University of Stanford, the financial – credit system of a developing country could be seen as a triumvirate comprising ministry of finance, central bank and specialized banks (such as banks for agricultural development, for trade or industry, etc.). They finance development projects and stimulate export. The main role of the central bank in this field is to generate seignorage with a view to meet the demand for cash by the ministry of finance. This demand, in its turn, depends on plans and development projects set forth by the ministry of planning and investment; and the PM office.

The more ambitious the development plan, the higher the rate of disbursement. And as a result, the money supply is increased accordingly to meet the demand for more disbursement. The rate of increases in the money supply is expressed by a ratio of the increase in the money supply to the price index, or M/P; or (M/M)(M/P); where the first part (m = M/M) is the rate of increase in the money supply; and the second one is the real money base that is proportional to the national income (referred to as Y).

In other words, the state can use the seignorage to finance development projects. This income is measured by the rate of issuing the money multiplied by the national income (mY). Result of this act, as everybody knows, is the inflation, expressed as π, that is measured by the difference between the rate of increase in the money supply and the rate of economic growth, or $\pi = m - g$. For example, the present growth rate of Vietnam is $g = 8.5\%$, the inflation rate $\pi = 12.5\%$, the rate of increase in the money supply will be alarming: m = M/M = 21%.

Based on these simple calculations, we can explain the process in which the inflation breaks out in Vietnam as follows: High growth rates in the first years of the 2000s allows Vietnam to increase the money supply without suffering an inflation rate that is higher than 5%. It's worth noting that in this period there were a lot of ineffective projects to build infrastructure and industrial parks, and to promote export. It's apparently that the longer the period of high growth, the more serious the shortcomings in the infrastructure development and production of energy, especially in industrial centers. To maintain the high growth rate, the average rate of disbursement of some 1% is usually raised higher, which leads to higher rates of inflation and increase in the money supply. This spiral of growth and inflation becomes more serious because of poor financial infrastructure, namely, the lack of independence for the central bank when facing the demand for more disbursement by the ministry of finance.

There is nothing wrong with the profit from issuing of money, or seignorage, but it is unreasonable to send this income to specialized banks, and in their turn, they could not invest this source of finance in effective and productive projects. They are only intermediaries who transfer capital supplied by the central bank to projects determined by the ministry of planning and investment. This ministry alone can not gather enough information have enough incentives to work out consistent development projects appropriate to local condition in individual provinces and the market demand. The bigger the inefficiency of investment in infrastructure projects, the wider the difference between the rate of increase in the money supply and the growth rate, which makes the danger of inflation more serious.

The above-mentioned analyses only discuss an aspect of internal disequilibrium. The inflation hike in late 2007 and early 2008 was also affected by the external disequilibrium that led to high reserve of foreign exchange by the central bank. In early 2006, one year before Vietnam became a WTO member, the high growth rate made the idea of borrowing money from international markets to increase the gross investment more attractive in the eyes of the leadership. In the trend of liberation, the Government encouraged organizations and companies to borrow from foreign partners. This measure apparently increased the reserve of foreign exchange of the central bank, but nobody realized that the danger of a high inflation rate had taken shape. Up to mid-2007, macroeconomic balances became unfavorable when a large amount of short-term FDI flowed into Vietnam. Of course, this is a direct result of Vietnam's accession to the WTO.

The surplus of foreign capital caused great troubles for policy makers. If the VND is allowed to rise against the dollar, it will affect badly labor-intensive industries making exports, such as agriculture, footwear and clothing. On the other hand, if the fixed exchange rate is maintained, billions of dollars from various sources (immigrant remittance, FDI, and sale of crude oil) will make the supply exceed the demand and the inflation rate go higher as seen today. Under such conditions, the real exchange was appreciated by the inflation, causing harm for the export business as an inevitable omen of disaster. The Government had to adopt a tight-money policy when it raised the lending interest rate and required reserve ratio. In a rather closed economy, such a policy can kill the inflation quickly, and allows the use of seignorage for development projects financed by the state. But in such an open economy as Vietnam's, this policy may be less effective. Private investors and state-owned concerns will avoid inflation tax and high lending rate imposed by commercial banks by securing loans from foreign lenders – a tendency that has been encouraged for the past several years. This makes the real money base (M/P) get contracted because of dollarization and widespread use of foreign capital. And as a result, the seignorage, (M/M)(M/P) will decrease unless the rate of increasing the money supply, or m = (M/M), gets higher. That is why it's hard to curb the inflation by carrying out solely a tight-money policy.

2. Poor quality of economic growth and low efficiency of investment as causes of inflation

To explain origins of the economic growth, economists introduce the model of total-factor productivity (TFP). They argue that the increases in the GDP may originate from increases in labor force and capital, and managerial and technological advances. Changes in the last factor may lead to increases in the TFP, or efficiency of the use of labor and capital.

The general equation is as follows:

$$GDP = Af(K,L)$$

where K is capital input; L is labor input; A represents the total-factor productivity (managerial and technical advances that improves the efficiency, etc.), the growth of the GDP (as %) is expressed in the following equation:

$$G_{GDP} = G_A + \beta K G_K + \beta L G_L$$

where GGDP is the growth rate; GA is the growth of total-factor productivity; GK is the growth of capital input; GL is the growth of labor input; β_K is the share of product surplus in the GDP and β_L is the share of labor cost in the GDP.

Based on this model and statistical data from the years 1991-2005, we work out shares of factors in the economic growth in this period. Calculations show that the average growth rate in that 15-year period is 7.5% a year; the share of capital (K) is 73%; labor (L) 2.8%; and TFP 24.2%. This means that to gain an average growth rate of 7.5% requires a 5.5% share of capital; a 0.2% share of labor and a 1.8% share of TFP. Results of our research are similar to ones published previously by the WB for the years 1991-2000. The TFP in Vietnam accounts for 2% to 1.1% of the growth rate in each 5-year period (the growth rate of the first period is higher than that of the second one), the capital output accounts for 70% - 80% of the growth rate. The calculations show that the high growth rate in Vietnam in the 15-year period come mainly from the capital input while the TFP and labor input account for only small proportions. This means that quality of the growth rate is poor because productivity and technological level are low. This conclusion also shows that technology-intensive industries and the human resource haven't developed as expected. Exports from Vietnam, besides crude oil, comprise mainly farm products and goods from labor-intensive industries that do subcontracts for foreign companies. These results allow us to conclude that the Vietnamese economy grows quantitatively, not qualitatively. This is a sign of a non-sustainable growth and a potential cause of inflation. This conclusion can be justified by some analyses of ICOR.

Vietnam's ICOR in recent years, according to our calculations, is between 4.5 and 4.7, that is, Vietnam should spend from 4.5 to 4.7 unit of capital to produce one unit in the GDP while this figure in other countries varies from 2.5 to 3.0. China is a big economy that gains a growth rate of 9% or 10% a year and its ICOR varies between 3.5 and 4.0. Thus, efficiency of investment in Vietnam is low. This also proves that we pay too much attention to quantitative growth instead of efficiency and qualitative development. The poor quality of growth and efficiency of investment are also factors affecting the inflation. Causes of the poor quality and efficiency are: time-consuming infrastructure projects, distribution of investment among too many projects and poor management of projects. In addition, many state-owned corporations have recently expanded their fields of activity to enter into other fields such as finance, banking and real estate. Their business expansion only means more public funds are injected into circulation. Regrettably, these funds might be put in investments that produced profit for the corporation itself or in unproductive projects for a very long time instead of being put in production of staple goods of the corporations. This practice is also one of factors producing the inflation.

Increases in foreign indirect and direct investment, immigrant remittance, and proceeds of bonds issued to foreign markets have forced the central bank to increase the money supply. Official reports say that in 2007 the money supply increased by 46%, the credit supply by 53% while these figures in 2006 were 26% and 27% respectively. The data show that increases in the credit supply led to ones in the money supply. Moreover, the increase in the credit supply was used for investing in the stock and realty markets that are two highly risky fields. Foreign experience shows that the increase in the credit supply along with poor legal infrastructure and big loans to the public sector can easily lead to credit risk and damage to the financial sector, which is one of causes of crisis and inflation. Other factors of the poor efficiency are red tape, less transparent information and corruption in such fields as management of land, construction and investment. All of these factors affect directly or indirectly the inflation.

3. Measures to curb inflation and ensure the economic growth taken by the Government

The Government has taken strong measures to curb the inflation. Namely, the SBV has decided to raise the ratio of required reserve, reduce the supply of credit to investors in securities and real estate, raise the rediscount rate and base rate, force commercial banks to buy T-bills and raise the exchange rate against the dollar, etc.

When the flow of foreign exchange keeps moving into Vietnam in forms of proceeds of sale of crude oil at a higher price, immigrant remittance and foreign direct investment, appreciating the domestic currency by degrees is better than maintaining a fixed rate. This measure allows considerable reductions in the money supply thereby easing the inflation. In the long run, however, the appreciation of the VND is only sustainable when the technological gap between Vietnam and the world is reduced. But in a shorter term, this measure also forces foreign investors to invest only in fields where the productivity is good enough to make profitable exports based on new prices. Although many experts still worry about this approach, the high growth rate and improved productivity in China will keep appreciating the renminbi in years to come. The appreciation of the VND now is not a choice but a must if Vietnam wants to avoid hyperinflation.

We can say that the decision to raise the VND against the dollar with a view to curbing the inflation is right, but it will be insufficient if no measure is taken to improve the quality and efficiency of investment and beef up cooperation between ministries and governmental agencies. The implementation of the monetary policy in the past few months shows that there is something contradictory in actions taken by the SBV and the Ministry of Finance. When the SBV tried to withdraw cash from the market, the Ministry of Finance asked for permission to allow foreign strategic investors to buy shares in foreign exchange and its suggestion was approved. Will this event become a precedent and the Foreign Exchange Ordinance passed by the NA in June 2005 need some amendment? Will the permission to buy local shares in foreign exchange turn the dollar into another kind of legal tender in Vietnam and force authorities to increase the money supply? Can the SBV control proceeds in foreign exchange from sale of crude oil, T-bonds, and shares gained by the Ministry of Finance? When tight-money measures were carried out, the Government required the SCIC to buy shares in order to prevent the VN-Index from falling. Both foreign and local analysts in the stock market agreed that this move might assure some investors for the time being, but in a long run, it produces no positive effects on the market because it has nothing to do with the expected profit with is considered as the drive of the stock market. It doesn't change the expectation as it can do in other channels of investment (as a result of the monetary policy), or alter source of finance and profitability of listed companies (because it can only affect the secondary market). Falls of the VN-Index come from many reasons besides investors' mentality. Firstly, in late 2007, many listed companies issued additional and bonus shares, thereby "diluting" values of their shares. Secondly, when the interest rate and gold price go high quickly, investment in securities becomes less attractive. Thirdly, high inflation rate affects badly all companies, including the listed ones (their production cost increases while the spending power falls), and their real profit contracts because of higher costs and lower sales. Fourthly, some listed companies, after gathering huge sums of money from the stock market in late 2007, invested in real estates, and when this market was frozen by decision to reduce the supply of credit, their value fell accordingly. They are causes of the falls in the VN-Index. This is also considered as a reaction of the market to reflect the real value of the companies. Is the effort to prevent the VN-Index from falling effective? Is it reasonable for the SCIC – a fund manager for the state capital – to spend a lot of money to save the stock market when commercial banks are badly in need of the VND to buy the dollar and the government has to cut its expenditure to curb the inflation?

4. Some more suggestions about policies

As everybody knows, the appreciation of the VND will promote import and hinder export in a period when the trade gap is very high. Exporters not only meet with difficulties when the VND price goes high, but also suffer high cost for inputs caused by the inflation and difficulties in selling the foreign exchange they earned because commercial banks refused to buy it. To gain a growth rate of 8% or 9%, the export should rise by at least 22% in 2008. The problem for the Government is how to support production of exports in order to achieve the said aims. It's impossible to maintain a fixed exchange rate, the only solution for the Government is to appreciate the VND by degrees. Moreover, it can restrict the public expenditure more strictly, require state-owned banks to buy foreign exchange from exporters, and restrict import in order to reduce the trade gap instead of selling or issuing more shares in foreign exchange, and buying securities. In addition, we should accept that some anti-inflation measures could lead to a lower growth rate.

In the long run, Vietnam needs policies and measures to improve the quality of economic growth and efficiency of investment. Some effective measures are: encouraging investments in production of exports with high added value instead of farm products and labor-intensive goods. Foreign experience shows that development of manufacturing industries always leads to improvements in the productivity and wages, and then, increases in prices of services in trading and financial centers. The wider the difference in productivity between manufacturing and service sectors, the higher the prices of real estate and other services, including food and entertainment. Thus a sustainable growth doesn't only means importing new technologies and sources of finance, and expansion of the assembling industry. Another important aspect is to enhance the supply of services.

In many cases, investment in the service sector could be done by stimulating the market. In the U.S. and China for example, show business and other kinds of entertainment develop very fast in big cities. They represent a big spending power in China today. Similarly, information technology, telecommunications, entertainment, production of TV programs, advertising, health care and banking services create a lot of new services with high productivity that helps reduce the price hikes. Development of trading and services will be limited when public services, communications and environmental protection are less developed. In these fields, stimulating the market is not enough and coordination problem should be solved properly.

One of methods is to exchange land for infrastructure works in which infrastructure building companies carry out these work for lots of land used for developing trading and residential centers. Similarly, local governments can make plan to clear old quarters in order to enlarge roads, and then, land along new roads can be sold at auction to retrieve investment or generate budget income. This approach can save authorities from tasks of making building plans and they can concentrate on zoning and coordinating resources. In this new role, the mechanism for supplying capital through relations between the ministry of finance, the central bank and specialized banks becomes unnecessary. By auctioning, capital from the private sector can be mobilized for development projects. The financial and banking sector can engage in trade in capital, instead of allocating the capital to various projects. The central bank can be saved from the task of supplying cash according to disbursement plan and it can concentrate in stabilizing the money market with its independent power. Thinking through, initial factors of such a process have made their appearance at various times and places. Facing the inflation and poor quality of the economic growth, more apparent changes in process of organizing and making development plans will come into being in order to create a stable and sustainable development ■

Reference

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